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In the Supreme Court of the United States

ASA INVESTERINGS PARTNERSHIP, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner was a valid partnership for federal tax purposes.

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In the Supreme Court of the United States

No. 00-008

ASA INVESTERINGS PARTNERSHIP, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 201 F.3d 505. The opinion of the Tax Court (Pet. App. 24a-58a) is reported at 76 T.C.M. (CCH) 325.

JURISDICTION

The judgment of the court of appeals was entered on February 1, 2000. The petition for rehearing and petition for rehearing en banc was denied on April 24, 2000. Pet. App. 67a, 68a. The petition for a writ of certiorari was filed on June 30, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1990, AlliedSignal decided to sell its interest in Union Texas Petroleum Holdings, Inc. Pet. App. 2a. In an effort to eliminate the tax liability flowing from the anticipated $400 million of capital gains arising from that sale, AlliedSignal contacted the Merrill Lynch Company concerning a tax shelter scheme that company was then promoting. *Id.* at 6a.

Merrill Lynch had developed a tax avoidance scheme that was designed to generate large paper losses for a corporation to use to shelter from tax an equal amount of capital gains realized by the corporation. Pet. App. 6a. The plan involved (i) creating a purported "partnership" that would have a foreign entity not subject to United States taxation as one of its partners and (ii) having that entity enter into a contingent installment sale to invoke the ratable basis recovery rule in Temporary Income Tax Regulations Under the Installment Sales Revision Act (Temp. Treas. Reg.) § 15A.453-1(c)(3)(i) (1981). The ratable basis recovery rule is a rule of tax accounting that applies to "contingent installment sales" of property reportable under the installment method of accounting provided by Section 453 of the Internal Revenue Code. A contingent installment sale is a transaction that extends over a period of more than one year and that has an indeterminate sales price on the date of sale. The ratable basis recovery rule allows the seller in a contingent installment sale to recover its basis in the asset over the period of the transaction. [1]

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[1] Merrill Lynch marketed the scheme to eight large United States corporations, including AlliedSignal, the real party in interest in this case, and Colgate-Palmolive Company, the real party in interest in *ACM Partnership* v. *Commissioner*, 157 F.3d 231, 233-

The tax shelter scheme being promoted by Merrill Lynch involved the following steps (Pet. App. 26a-27a):

(1) AlliedSignal was to enter into a partnership with a foreign entity that was not subject to United States taxation.

(2) Upon the formation of the partnership, the foreign entity was to have the overwhelming majority partnership interest while AlliedSignal would own a distinct minority interest.

(3) To come under the ratable basis recovery regulation, the partnership was to purchase short-term private placement securities that were eligible for the installment method of accounting provided under Section 453 of the Code and was then promptly to sell those instruments for a large amount of cash and a comparatively small amount of debt instruments whose yield over a fixed period of time was not ascertainable. The gain from the sale of the private placement securities was to be allocated among the partners for federal tax purposes in accordance with their percentage partnership interests.

(4) Under Temp. Treas. Reg. § 15A.453-1(c)(3)(i), the partnership would claim a large "basis" in the debt instruments acquired in exchange for the private placement securities.

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234 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999). In *ACM*, the court of appeals determined that, by creating paper gains and paper losses, the Merrill Lynch transaction lacked economic substance. The court therefore held that neither the paper gains nor the paper losses reported on the partnership returns were to be recognized for federal tax purposes. 157 F.3d at 263.

(5) AlliedSignal would then acquire a majority interest in the partnership during its following taxable year by purchasing a portion of the interest owned by the foreign entity.

(6) The partnership would thereafter distribute the debt instruments with the large basis to AlliedSignal and distribute cash to the foreign entity in a partial redemption of their partnership interests.

(7) AlliedSignal would then sell the debt intruments to a third party. Because the basis of the instruments would then greatly exceed their value, this disposition would result in a large paper loss. AlliedSignal would then use the paper "loss" from the transaction to shelter from tax the capital gain it had realized from the sale of its interest in UTP. The partnership would then terminate.

The foreign partner in the proposed partnership was to be a Netherlands financial institution named Algemene Bank Netherland N.V. (ABN). Pet. App. 7a. ABN entered into the arrangement as an accommodation to AlliedSignal, which was a customer of its banking services. *Ibid.*[2] AlliedSignal paid all of the costs incurred by ABN in this transaction and also paid ABN a fee of $5 million for its participation. *Id.* at 8a.

The Merrill Lynch scheme was implemented in the spring of 1990. AlliedSignal and a newly-created, wholly-owned subsidiary entered into a "partnership" with two Netherlands Antilles "special purpose cor-

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[2] ABN also served as the foreign partner in other similar arrangements marketed by Merrill Lynch to large United States corporations. Pet. App. 7a.

porations." Pet. App. 9a. The special purpose corporations were controlled by foundations that were, in turn, controlled by ABN. *Ibid.* The AlliedSignal subsidiary was known as AlliedSignal Investment Corporation (ASIC); the Netherlands Antilles corporations were known as Dominguito Corporation N.V. (Dominguito) and Barber Corporation N.V. (Barber). *Ibid.* The partnership that they formed is petitioner ASA Investerings Partnership.

AlliedSignal contributed $99 million in exchange for a 9% partnership interest. Pet. App. 34a. ASIC contributed $11 million in exchange for a 1% partnership interest. *Ibid.* Dominguito contributed $594 million in exchange for a 54% partnership interest. *Ibid.* Barber contributed $396 million in exchange for a 36% partnership interest. *Ibid.*

On April 25, 1990, petitioner purchased $350 million of five-year floating rate notes issued by the Long Term Credit Bank of Japan and $500 million of five-year floating rate notes issued by Sumitomo Bank Capital Markets, Inc. Pet. App. 9a-10a. Between May 17, 1990, and May 24, 1990, ASA sold the private placement notes to two banks for $681,300,000 in cash and 11 London Interbank Offering Rate (LIBOR) Notes. *Id.* at 10a. The LIBOR is the primary fixed income rate used in Euro markets. *Id.* at 26a n.1. LIBOR Notes are instruments that pay variable amounts at three-month periods (reflecting adjustments in the LIBOR during the period) on a fixed sum ("a notional principal amount").[3] The LIBOR Notes

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[3] The owner of a LIBOR Note effectively purchases a stream of payments for a certain period that includes a recovery of principal as well as an interest component. The purchaser of a LIBOR Note

purchased by petitioner provided for quarterly payments for 20 quarters commencing August 31, 1990, on a notional amount of $434,749,000. *Id.* at 37a.

2. On its partnership tax return for the 1990 taxable year (ending on May 31, 1990), petitioner treated the sale of the private placement notes as an "installment sale" under Section 453(b) of the Internal Revenue Code and as a "contingent payment sale" under Temp. Treas. Reg. § 15A.453-1(c). Pet. App. 38a-39a. Petitioner therefore reported a gain of $539,443,361 from these transactions for 1990, which reflected the excess of the cash received from the sale of the private placement notes ($681,300,000) over the portion of the basis in the LIBOR Notes recovered during that year (computed by ASA to be $141,856,639). *Id.* at 10a-11a.[4] The gain was allocated to the partners based upon their ownership interests: $48,531,902 was allocated to AlliedSignal; $5,394,434 was allocated to ASIC; $291,299,415 was allocated to Dominguito; and $194,199,610 was allocated to Barber. *Id.* at 39a. Barber and Dominguito did not pay any United States or other tax on the gain allocated to them from the sale of the private placement notes.

On August 21, 1990, petitioner distributed the LIBOR Notes acquired in May 1990 to AlliedSignal and ASIC in partial redemption of their interests in petitioner, and distributed cash and commercial paper to Dominguito in partial redemption of its interest in

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makes a profit if the rate rises, and incurs a loss if the rate declines.

[4] The parties stipulated in the Tax Court that petitioner had erred in computing the gain reported on its 1990 return, and that the correct amount of the reported gain was $539,364,656. Pet. App. 11a n.3.

petitioner. Pet. App. 41a. The LIBOR Notes distributed to AlliedSignal were valued at $167,469,860; the notes distributed to ASIC were valued at $2,866,140; the cash and commercial paper distributed to Dominguito totaled $116,279,033. *Ibid.* AlliedSignal determined that its adjusted basis in the LIBOR Notes distributed to it was $697,348,518, and that ASIC's adjusted basis in the Notes distributed to it was $11,934,677. *Id.* at 42a.

On September 6, 1990, AlliedSignal sold some of its LIBOR Notes to Unibank A/S for $17,502,543 in cash. AlliedSignal reported a capital loss of $65,097,013 on that sale. Pet. App. 42a. In November 1990, AlliedSignal sold other LIBOR Notes in two separate transactions. AlliedSignal sold some of those Notes to Generale Bank for $17,129,250 in cash, and reported a capital loss of $65,714,370 on the sale. *Ibid.* AlliedSignal sold other LIBOR Notes to Unibank for $15,822,310 in cash, and reported a capital loss of $65,255,321 on the sale. *Ibid.* For its 1990 taxable year (ending December 31, 1990), AlliedSignal thus reported a total of $196,066,704 in capital losses from the sale of the LIBOR Notes. *Ibid.* Setting those losses off against the capital gain reported by AlliedSignal and ASIC from petitioner's sale of the private placement notes ($53,926,336), AlliedSignal reported a 1990 tax loss of $142,140,367 from the Merrill Lynch transaction. AlliedSignal then carried this loss back to its 1987 taxable year and claimed a refund of taxes paid during that year. *Ibid.*

On November 22, 1991, petitioner distributed $91,898,434 to Dominguito in redemption of 7.57% of Dominguito's remaining interest in petitioner. Pet. App. 43a. On December 5, 1991, AlliedSignal made a $1,631,250 payment to ABN. This amount consisted of

(i) a $765,147 payment that reflected the amount by which the income from petitioner to Barber and Dominguito fell below ABN's LIBOR-based funding costs, (ii) a $634,853 payment that constituted the remainder of ABN's $5 million fee for participating in the Merrill Lynch transaction (plus interest), and (iii) a $231,250 interest payment that reflected the fact that ABN had allowed $92 million to remain in the partnership coffers longer than the parties had anticipated. *Ibid.* [5]

On April 8, 1992, petitioner distributed $76,961,863 in cash to Dominguito in redemption of Dominguito's remaining interest in petitioner. Pet. App. 44a. On May 28, 1992, ASIC transferred its 1.26% interest in petitioner to AlliedSignal. Shortly thereafter, AlliedSignal liquidated the partnership. *Ibid.*

In the fall of 1992, AlliedSignal concluded the intended sale of its interest in Union Texas Petroleum Holdings, realizing a capital gain of $264,667,000 on that transaction. Pet. App. 45a-46a. AlliedSignal subsequently sold its remaining LIBOR Notes for $33,431,000. *Id.* at 46a. On its 1992 consolidated federal income tax return, AlliedSignal reported a capital loss of $396,234,738 from its sale of the LIBOR Notes and used this loss to offset the $264,667,000 in capital gain realized on the sale of its interest in Union Texas Petroleum Holdings. The 1992 losses remaining after application against the gains from the Union Texas sale were carried back to offset capital gains realized by AlliedSignal during 1989 and 1991 and carried forward

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[5] In addition to participating in the Merrill Lynch transaction, petitioner purchased certain interest-bearing instruments during its existence, most notably commercial paper issued by AlliedSignal. See Pet. App. 39a-40a.

to offset capital gains realized during 1993, 1994, and 1995. *Ibid.*

The transaction costs and expenses incurred by AlliedSignal on these transactions—including the fees paid to Merrill Lynch and ABN—totaled almost $25 million. Pet. App. 22a. Although AlliedSignal claimed a tax loss exceeding $538 million from the transaction arranged by Merrill Lynch, it actually made an economic profit of approximately $3.6 million from its participation in the transaction. *Id.* at 22a-23a.

3. The Internal Revenue Service audited petitioner's partnership returns for 1990 through 1992 and determined that the ABN affiliates had not entered into a valid partnership with AlliedSignal (and ASIC). The Commissioner therefore adjusted petitioner's returns to allocate all the gains and losses reported by petitioner to AlliedSignal and ASIC.[6]

Petitioner filed a petition in Tax Court to contest the proposed adjustments.[7] The Tax Court, however, sustained the Commissioner's determinations and agreed with the Commissioner that petitioner was not a valid partnership for federal tax purposes. Pet. App.

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[6] The Commissioner also proposed alternative adjustments that reflected other theories. Neither the Tax Court nor the court of appeals addressed those theories.

[7] As a result of amendments to the Internal Revenue Code made by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, tax litigation involving, partnership items now is conducted in a single proceeding in the name of the partnership. Following the completion of such litigation, appropriate computational adjustments are made to the tax returns of each of the partners to reflect the results of the partnership level litigation. See 26 U.S.C. 6221-6233. The instant litigation thus was conducted in the name of petitioner ASA Investerings Partnership. AlliedSignal, however, is the real party in interest.

24a-58a. The court observed that the existence of a partnership for federal tax purposes depends on whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id.* at 47a-48a (quoting *Commissioner* v. *Culbertson*, 337 U.S. 733, 742 (1949)). In applying that test, the Tax Court disregarded Barber and Dominguito—because those entities were simply ABN's "agents"—and focused on the purported business purpose of AlliedSignal and ABN. Pet. App. 48a-49a. The court determined that AlliedSignal and ABN had not in fact joined together for the purpose of investing in interest-bearing instruments as petitioner contended (*id.* at 49a):

> AlliedSignal and ABN had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses to shelter an anticipated capital gain. In pursuing this goal, AlliedSignal chose to ignore transaction costs, profit potential, and other fundamental business considerations. In fact, AlliedSignal's Board and the Board's Executive Committee focused only on potential tax benefits when they approved the plan.
>
> In contrast, ABN entered into the venture for the sole purpose of receiving its specified return. This return was independent of the performance of ASA's investments (e.g., the profitability of the LIBOR notes) and the success of the venture (i.e., whether AlliedSignal succeeded in generating capital losses). Moreover, as will be explained, ABN did not have any profit potential beyond its specified return and did not have any intention of being AlliedSignal's partner. * * *

The Tax Court concluded that the partnership was a "facade," that the income allocations provided for by the partnership agreement "were merely an artifice to pay ABN's specified return," and that the loss allocations in the agreement were disingenuous because "ABN * * * did not intend to, nor did it actually, share in ASA's losses." Pet. App. 50a-51a. The court noted that, by separate agreement with ABN, AlliedSignal bore all of the expenses of ABN and its affiliates in these transactions. *Id.* at 53a. The Tax Court concluded that the relationship between AlliedSignal and ABN was merely a contractual, debtor-creditor relationship, not a partnership. *Id.* at 55a-58a.

4. The court of appeals affirmed. Pet. App. 1a-23a. The court ruled that the Tax Court decision was "sound in its basic inquiry, trying to decide whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance." *Id.* at 18a. The court of appeals concluded that the factual record "amply supports" the Tax Court's finding "that none of the supposed partners had the intent to form a real partnership * * *." *Id.* at 23.

ARGUMENT

The fact-intensive determination of the courts below that petitioner was not a valid partnership for federal tax purposes properly applies the decisions of this Court and does not conflict with the decisions of any other court of appeals. Further review is therefore not warranted.

1. a. In *Commissioner* v. *Tower*, 327 U.S. 280, 286 (1946), and *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), this Court set forth standards for determining

whether parties have created a valid partnership for federal tax purposes. In *Tower*, the taxpayer had managed and controlled a corporation engaged in the manufacturing and sale of sawmill machinery and wood and metal stampings for ten years. 327 U.S. at 285. In an effort to reduce his taxes, the taxpayer dissolved the corporation and formed a purported partnership with his wife. *Ibid.* The purpose of that arrangement was to split the income from the business between the husband and wife and thereby reduce the net tax on that income.

This Court determined that a valid partnership had not been created for federal tax purposes and that the husband was therefore subject to tax on the entire income from the business. The Court stressed that the question whether a valid partnership had been formed for federal tax purposes is factual in nature and centers on whether the alleged partners "really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." 327 U.S. at 287. The Court concluded on the record before it that "[t]here was * * * more than ample evidence to support the Tax Court's finding that no genuine union for partnership business purposes was ever intended and that the husband earned the income." *Id.* at 292. In the Court's view, a contrary conclusion "would [have] mean[t] ordering the Tax Court to shut its eyes to the realities of tax avoidance schemes." *Id.* at 289.

In *Culbertson*, the taxpayer had been a partner in a partnership engaged in the cattle business. When his partner expressed the desire to terminate the business, the taxpayer formed a purported partnership with his four sons to continue the business. This Court held that the critical question in determining whether the taxpayer and his sons had created a valid partnership

was whether, "considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." 337 U.S. at 742.

b. The Tax Court and the court of appeals correctly applied the standards set forth in *Tower* and *Culbertson* in concluding that petitioner was not a valid partnership for federal tax purposes. The nature of the relationship between AlliedSignal and its putative partners belies the existence of a legitimate partnership. AlliedSignal formed petitioner for the sole purpose of creating artificial tax losses for itself. Pet. App. 6a, 22a. Its putative foreign partners could not realize an economic gain, and could not suffer an economic loss, from their participation in petitioner. *Id.* at 19a-22a. Instead, AlliedSignal paid the parent corporation of the putative partners a substantial, guaranteed fee for creating the subsidiaries to play the role of partners to AlliedSignal. *Ibid.* The court of appeals correctly concluded that the record of this case amply supports the Tax Court's findings that, in these circumstances, no legitimate partnership relationship had been formed for federal tax purposes between AlliedSignal and ABN. *Id.* at 23a.[8] Further review of the

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[8] Petitioner errs in asserting (Pet. 24-25) that the court of appeals misapplied the standards set forth in *Culbertson* by ignoring the fact that ABN allegedly made a "capital contribution" to the putative partnership. In *Culbertson*, this Court stressed that even a legitimate capital contribution does not necessarily render an arrangement a partnership for federal tax purposes. 337 U.S. at 742. Instead, the controlling inquiry is whether the record as a whole reveals that "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Ibid.* The courts below correctly applied that standard in this case. See Pet. App. 18a.

factual determinations "concurred in by two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)) is not warranted. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. Petitioner errs in contending (Pet. 16) that the decision in this case conflicts with the "principles" enunciated by this Court in *Moline Properties* v. *Commissioner*, 319 U.S. 436 (1943). The *Moline Properties* case addressed the circumstances under which a corporation is to be recognized for federal tax purposes. Petitioner claims (Pet. 16-21) that, in *Moline Properties*, the Court concluded that a corporation should be recognized for federal tax purposes if it either served a business purpose or engaged in business activity. Petitioner contends that the decision in this case erroneously collapsed that two-part test into a test that focuses solely on whether the entity possessed a valid business purpose.

a. Petitioner's reliance on *Moline Properties* reflects a fundamental misunderstanding of that decision. The issue in *Moline Properties* was whether income from the sale of real property owned by a corporation was taxable to the corporation (as the Commissioner contended) or to the corporation's sole shareholder (as the taxpayer contended). The corporation had been formed long before the taxable years in issue to serve as a security device in connection with certain real property owned by the shareholder. Relying on the corporation's status as a "separate taxable entity," this Court ruled in favor of the Commissioner (319 U.S. at 438-439; footnotes omitted):

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of

> incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

The Court emphasized in *Moline Properties* that there were exceptions to the rule that generally recognizes the existence of the corporate form, including cases involving "frauds on the tax statute." 319 U.S. at 439. The Court concluded that the income earned by the corporation was taxable to the corporation in that case, however, because the corporation had served a legitimate business purpose (relieving its shareholder of pressure from his creditors) and had engaged in legitimate business activity (leasing a part of its property for a substantial rental). *Id.* at 439-440. In the Court's view, these facts reflected the fact "that the [corporation] had a tax identity distinct from its stockholder." *Id.* at 440.

The reasoning and holding of the Court in *Moline Properties* has no application to the question whether parties have formed a valid partnership for federal tax purposes. The decision in *Moline Properties* was based on the fact that a corporation is a "separate taxable entity"—an entity that, by law, is subject to tax on the income it earns. See 26 U.S.C. 11(a). Because a corporation is a separate taxable entity, the shareholders of the corporation are ordinarily *not* subject to tax on the corporation's income. By contrast, a partnership is not itself a separate taxable entity for federal tax purposes. See 26 U.S.C. 701. Instead, the income, losses, and other tax items of the partnership

are attributed to its partners and are taxed at the partnership level. See 26 U.S.C. 702(a). Because partnerships are *not* separate taxable entities, the decision in *Moline Properties*, by its very terms, has no bearing on whether parties have formed a valid partnership for federal tax purposes. Instead, as this Court has itself emphasized, that issue is to be resolved by applying the principles articulated by this Court in *Tower* and *Culbertson*.

In *Tower* and *Culbertson*, this Court neither cited nor relied on its prior decision in *Moline Properties*. It is thus obvious, in this context, that the principles articulated in the more recent and relevant decisions of *Tower* and *Culbertson*, and not the reasoning of the prior and unrelated decision in *Moline Properties*, establish the controlling test for determining whether taxpayers have entered into genuine partnerships for federal tax purposes. Indeed, if (as petitioner erroneously contends) the "business activity" test set forth in *Moline Properties* were controlling in determining the existence of a valid partnership for tax purposes, both *Tower* and *Culbertson* would have been decided differently—in favor of the taxpayers. Unlike petitioner, the purported partnerships involved in *Tower* and *Culbertson* were engaged in legitimate businesses. This Court concluded that these entities nonetheless did not qualify as partnerships for federal tax purposes in light of the intent of the putative partners and the nature of their relationship. 327 U.S. at 287; 337 U.S. at 742. The court of appeals did not err in this case in following the same reasoning applied by this Court in *Tower* and *Culbertson*. See Pet. App. 18a.

b. Moreover, nothing in this Court's decision in *Moline Properties* validates blatant tax-avoidance schemes such as the one that the parties sought to construct in

this case. *Moline Properties* stands for the straightforward proposition that a corporation that serves a legitimate business purpose or that is engaged in legitimate business activity is ordinarily to be taxed on the income it earns. 319 U.S. at 439. Nothing in that decision, however, suggests that courts are required to treat a relationship that exists only to implement a tax avoidance scheme as a valid business entity for federal tax purposes. To the contrary, the Court stressed that its description of the separate tax status of corporations in *Moline Properties* has "recognized exceptions" and does *not* apply in cases involving attempts to perpetrate "frauds on the tax statute * * *." *Ibid.* It is precisely such a "sham or unreal" (*ibid.*) device to perpetrate an evasion of tax liability that the Merrill Lynch scheme seeks to accomplish here—for AlliedSignal seeks to obtain a $538 million tax loss from participation in a relationship that was developed and structured solely to achieve "phantom" losses for a taxpayer that would, in fact, incur no genuine economic loss from the scheme. *ACM Partnership* v. *Commissioner*, 157 F.3d 231, 245 (3d Cir. 1998) (holding that the Merrill Lynch scheme creates "phantom" losses that are not to be recognized for tax purposes), cert. denied, 526 U.S. 1017 (1999); Pet. App. 22a-23a.[9]

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[9] Other courts have noted that petitioner's contention (Pet. 17-19) that the court in this case erroneously collapsed the "two-part test" of *Moline Properties* into a unitary "business purpose" test "attempts to create a distinction where none exists." *Zmuda* v. *Commissioner*, 731 F.2d 1417, 1420 (9th Cir. 1984). "Business purpose" and "business activity" are two sides of the same coin; both terms are directed at the question whether a corporation is serving a legitimate purpose.

In the present case, the court did not suggest that a corporation engaged in *legitimate* business activity will not be recognized for

c. Petitioner errs in contending (Pet. 20-21) that the decision in this case is in "direct conflict" with *Northern Indiana Public Service Co.* v. *Commissioner*, 115 F.3d 506 (7th Cir. 1997), and *Gregg Co. of Delaware* v. *Commissioner*, 239 F.2d 498 (2d Cir. 1956), cert. denied, 353 U.S. 946 (1957). In those cases, the courts of appeals made fact-specific determinations that the *corporations* in question were engaged in *legitimate* business activities. As discussed above, cases involving corporations do not require the same analysis that *Tower* and *Culbertson* require for partnerships. Moreover, in the present case, petitioner did *not* engage in legitimate business activities. Instead, petitioner was simply a facade constructed in a misguided effort to allow Allied-Signal artificially to employ "phantom" losses to avoid payment of the taxes it owed on the significant capital gains that it derived from the sale of its subsidiary. See pages 2-9, *supra*.

3. Petitioner also errs in urging a newly minted contention that the decision in this case conflicts with *Evans* v. *Commissioner*, 447 F.2d 547 (7th Cir. 1971), "with respect to the proper roles of IRC Sec. 704(e)(1) and *Culbertson* in determining whether persons are partners in a partnership" (Pet. 22). Petitioner did not

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federal tax purposes. On the contrary, it observed that "[i]t is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax." Pet. App. 17a. The court correctly held, however, that in some cases a purported business activity is nothing more than a facade for an abusive tax avoidance scheme. See *ibid.* ("When the business purpose doctrine is violated, such structuring is deemed to have gotten out of hand, to have been carried to such extreme lengths that the business purpose is no more than a façade."). Neither *Moline Properties* nor any other case cited by petitioner suggests that courts are powerless to prevent such schemes from coming to fruition.

make any argument based upon Section 704(e)(1) until its reply brief on appeal. The court of appeals properly declined to address that issue which petitioner belatedly sought to inject into this case. Because the court had no occasion to, and did not, address Section 704(e) in its opinion, its decision in this case obviously does not conflict with any decision (such as *Evans* v. *Commissioner*) that *has* addressed Section 704(e).[10]

Petitioner's invocation of Section 704(e)(1) is, in any event, entirely without merit. Section 704(e)(1) provides an objective, statutory standard for determining whether a particular "person" is a "partner" in a partnership. It does *not* provide a standard for determining whether an arrangement that purports to be a partnership is to be recognized as a valid partnership for federal tax purposes.[11] Section 704(e)(1) states that "[a] person shall be recognized as a partner * * * if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." 26 U.S.C. 704(e)(1). This statute assumes the existence of a genuine partnership engaged in a *legitimate* income-producing business. See Treas. Reg. 1.704-1(e)(1)(iv) (1981) ("Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the

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[10] In any event, *Evans* v. *Commissioner* involved the analytically distinct question whether a partner in an indisputably genuine partnership made a valid transfer of his partnership interest to his wholly-owned corporation. See 447 F.2d at 551-552. The Seventh Circuit resolved that factual issue in favor of the taxpayer in that case. *Id.* at 552.

[11] This Court's decisions in *Tower* and *Culbertson* provide that standard. See pages 11-13, *supra*.

business conducted by the partnership."). The statute thus has no application to, and does not validate, sham arrangements created by tax planners to conjure forth "phantom" losses as part of tax avoidance schemes. When, as in the present case, there is no genuine partnership, there can be no actual partners.

4. Petitioner's rhetorical suggestion (Pet. 25) that this case "raises fundamental issues affecting partnership taxation in a nonfamily setting" is unfounded. This fact-specific case involves a blatant tax-avoidance scheme that offers up "phantom" losses that courts have consistently and properly refused to validate.

Equally unpersuasive is petitioner's contention (Pet. 15-16, 26) that this Court should grant the petition for certiorari because the Court of Appeals for the District of Columbia Circuit is the only circuit to which appeals may be taken by partnerships that are no longer in existence. The question of the validity for federal tax purposes of a purported partnership can, of course, arise in other circuits. In any event, the fact that the District of Columbia Circuit is the appellate venue for extinct partnerships provides no grounds for review of the factual determinations of the courts below that petitioner was merely an artifice for tax avoidance and was not a valid partnership for federal tax purposes.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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